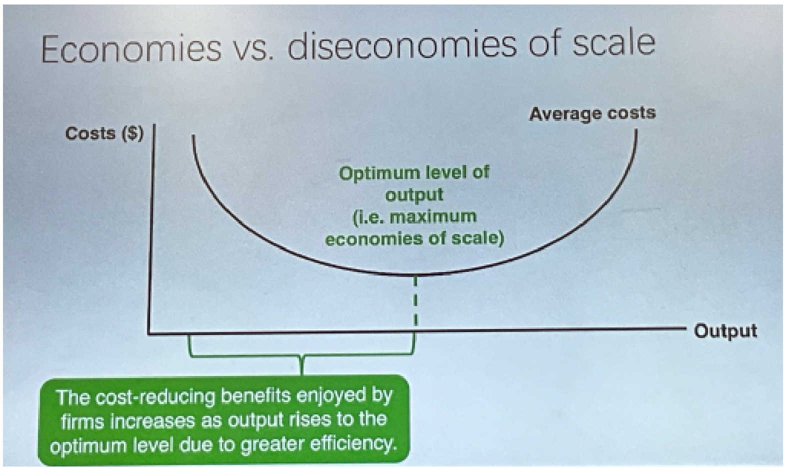
1.5 Growth and evolution

- Economies vs. diseconomies of scale

  - Economies of scale

    Economies of scale is when average costs of production decrease as the organization increases the size of its operations.i.e. it is the cost-reducing benefits enjoyed by firms engaged in large scale operations

  - Diseconomies of scale

    Diseconomies of scale is when an organization becomes too large, causing productive inefficiencies that result in an increase in average costs of production.i.e. it is the cost disadvantages of growth when the business becomes too big

- Economics and diseconomics of scale
  - Internal economies of scale
    - These are economies of scale that occur inside the firm
    - They are within the firm's control
    - Types of internal economies of scale
      - Technical economies

        Large firms can use sophisticated capital and machinery to mass produce their goods
        The high fixed costs of their equipment and machinery are spread over the huge scale of output
        This results in the reduction of average costs of production

      - Financial economies

        Large firms can borrow large sums of money at lower rates of interest
        This is because they are seen as less risky to financiers
        This results in the reduction of the costs of borrowing finance

      - Managerial economies

        Large firms divide managerial roles by employing specialist managers
        Small firms are less able to do so. e.g., a sole trader often has to fulfill the functions of marketer,accountant and production manager
        This results in the fall of average costs due to higher productivity

- Marketing economies
  Large firms benefit from selling in bulk
  High costs of advertising can also be spread by large firms through using the same marketing campaign across the world
- Purchasing economies
  Large firms benefit from buying resources in bulk
  Discounts are usually given to bulk purchases
  Large firms are able to purchase enormous quantities, so they get the biggest discounts
- Risk-bearing economies
  Conglomerates can spread fixed costs across a wide range of business operations
  Unfavorable trading conditions for some products can be offset by more favorable trading conditions in their other products.

- Examples of internal diseconomies of scale
  - Lack of control and coordination
    As the span of control is likely to increase and communication problems
  - Poorer working relationships
    Senior managers are more likely to become detached from those lower down in the organizational hierarchy, thereby making them feel distanced or out of touch
  - Lower productive efficiency from outsourcing because workers become bored with performing repetitive tasks
  - Bureaucracy (excessive administration, paperwork and company policies)
  - Complacency (a lack of awareness oi genuine risks or deficiencies) is most likely to reduce productivity thereby raising unit costs of production
- External economies of scale
  - Types of external economies of scale
    - Technological progress
      Technological innovations increase productivity within an industry with significant cost savings
      E.g. the internet has revolutionized business by offering e-commerce
      This offers cost savings as the location of premises can be in more affordable areas
    - Improved transportation networks
      Globalized transportation networks have enabled firms to import raw materials and finished goods that have been manufactured at much lower costs
      Increased convenience from improved logistical networks allows for faster deliveries at lower costs
    - Abundance of skilled labor
      Certain locations may benefit from reputable education and training facilities
      Local businesses benefit from this by having a suitable pool of educated and trained labor
      This reduces costs of recruitment and training
    - Regional specialization
      Certain locations or countries have established reputations for specializing in specific goods and services

Firms in those locations benefit from having access to specialist labor, sub-contractors and suppliers
They are also able to charge a premium price for their products

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- Examples of external diseconomies of scale
  - Higher rents

    Too many businesses locating in a certain area causes land to become even more scarce

  - Higher pay and financial rewards since workers have greater choice from a large number of employers in the local area
  - Traffic congestion results from too many businesses being located in an area

- Growth
  - Internal growth
    - Methods of internal growth

      Changing prices
      Effective promotions
      Product innovation
      Increased distribution
      Preferential credit for customers
      Capital expenditure
      Staff training and development
      Providing overall value for money

    - Advantages and disadvantages of internal growth
      - Advantages
        - Better control and coordination
        - Relatively inexpensive
        - Maintains corporate culture
        - Generally, less risky
      - Disadvantages
        - Diseconomies of scale
        - Restructuring of the form of ownership may be needed
        - May lead to dilution of control and ownership
        - Slower method of growth

- External growth
  - Advantages and disadvantages of external growth
    - Advantages
      - Quicker than organic growth

        External growth tends to be a faster way to grow and diversify as external resources and finances are used
      - Synergies

        Businesses can benefit from a greater pool of skills, knowledge and the expertise of external parties
      - Reduced competition

        External growth is a relatively quick method of reducing the degree of competition and raising the firm's market share
      - Economies of scale

        Rapid external growth can help businesses to gain access to larger markets and hence economies of scale from operating on a larger scale
      - Spreading of risks

        External growth enables businesses to benefit from diversification. Hence, firms face fewer risks overall from failures in any particular aspect of its business operations
    - Disadvantages
      - More expensive than internal growth
      - Greater risks

        Inadequate knowledge of new markets and the greater uncertainties of extenal growth create greater risks
      - Regulatory barriers

        Such as acquisitions and takeovers, can be blocked by governments if the move is deemed to be anti-competitive
      - Potential diseconomies of scale

        Increased complexities of internal growth can equally cause inefficiencies and hence a rise in average costs
      - Organizational culture clash

        It is often difficult to combine different cultures and management styles, especially if external growth leads to a change in the nature and culture of a business
- Size of a business
  - Measuring the size of a business
    - The size of a business can be measured in several ways
      - Market share
      - Total sales revenue
      - Size of workforce
      - Profit
      - Capital employed

The value of the firm's capital investment as recorded on its balance sheet

- Generic benefits of being a large business
  - Economies of scale
  - Lower prices
  - Brand recognition

    Familiarity with the brand allows large businesses to sell to a wider market
  - Brand reputation

    Larger firms tend to be more trusted due to their brand image and brand reputation
  - Value-added services

    Larger firms have the resources to provide a wider range of services for their customers, such as longer opening hours and interest-free credit instalments
  - Greater choice
  - Customer loyalty

    The above benefits mean that more customers are likely to remain loyal to the business, its products and its brands due to the perceived trust and overall value for money
- Generic benefits of being a small business
  - Cost control

    Owners of small firms might not want to expand as they could face higher unit costs
  - Loss of control

    Dilution of ownership and control for the original owners
  - Financial risks

    As the costs of running a large global business are huge (e.g. the costs of R&D, marketing, recruitment and training), the financial risks are also high
  - Government aid

    Financial support in the form of grants and subsidies can be offered to small businesses to help them start up and to develop
  - Local monopoly power

    Small businesses may enjoy being the only firm in a remote town
  - Personalized services

    Smaller firms are more likely to have the time to devote to individual customers
  - Flexibility

    If a sole trader runs a beauty salon that is unsuccessful, then s/he might change the business to something completely different, such as a children's toy shop

- Intercompanies
  - Mergers and acquisitions(M&As)
    - Mergers

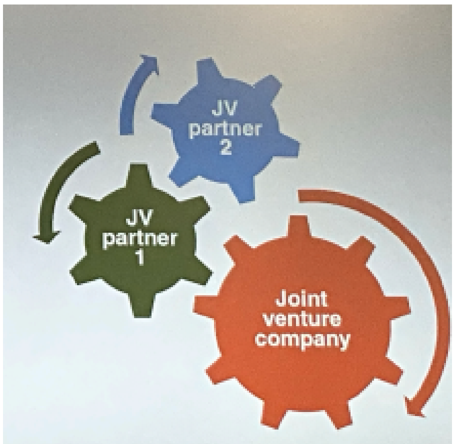
      Mergers take place when two firms agree to form a new company with its own legal identity
    - Acquisitions

      Acquisitions occur when a company buys a controlling interest in another firm with the permission and agreement of its board of directors

- Takeovers

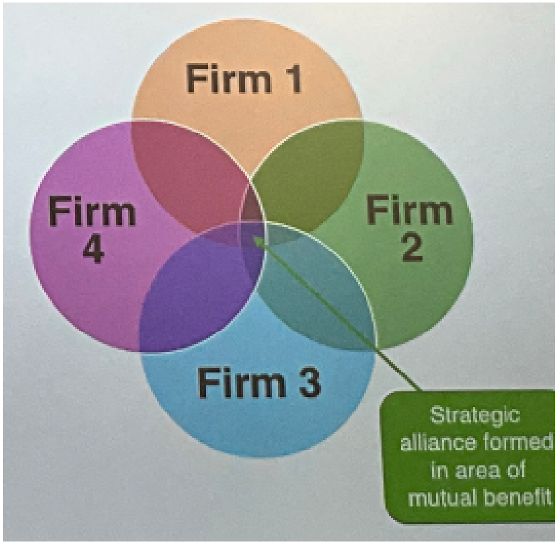
  Takeovers occur when a company purchases a controlling stake in another company without the permission and agreement of the company or board of directors
  They are also known as hostile takeovers

- JVs and SAs
  - Joint ventures (JVs)

    A joint venture occurs when two or more businesses split the costs, risks, control and rewards of a business project
    In doing so, the parties agree to set up a new legal entity

  - Strategic alliances (SAs)

    Strategic alliances occur when two or more businesses cooperate in a business venture for mutual benefit
    The firms in the SA share the costs of product development,marketing and operations
    However, SA firms remain independent organizations

  - Benefits and drawbacks of JVs and SAs
    - Benefits
      - Synergy

        The pooling of experiences, skills and resources of the collaborating firms in the JV should create synergies

      - Spreading costs and risks

    Financial costs, risks and losses are shared in a JV thereby helping to reduce the financial burden on any single organization

- Entry to new/foreign markets

    Joint ventures are used by companies to enter foreign countries by forming an agreement with local firms, in some cases, national laws make JVs the only option for businesses wishing to enter foreign markets

- Relatively cheap

    Mergers and acquisitions can be highly expensive as they entail lengthy legal procedures and administrative costs. The cost of a hostile takeover is often unknown.By contrast, JVs are cheaper to establish and are easier to pull out of should this be necessary

- Drawbacks
    - Partners in a JV have to rely heavily on the resources and goodwill of their counterparts
    - There is also likely to be a dilution of the brands, yet firms spend huge amounts of money trying to develop their own brands
    - Whenever companies work together on a project, there is always the possibility of organizational culture clashes that can lead to operational problems and conflicts for the joint venture

- Franchising
    - Introduction
        - Franchising is a form of business ownership whereby a person or business buys a license to trade using another firm's name, logos, brands and trademarks
        - The agreement is between the

            Franchisor: the firm selling the license, and the
            Franchisee: the entrepreneur buying the license

    - Benefits
        - Franchisors
            - The company can experience rapid growth without having to risk large amounts of money as the franchisee pays for the rights. Hence, it can be cheaper and faster than internal growth
            - It allows the company to have a national or international presence without the higher costs of internal growth or M&As (as the franchisee helps to finance the expansion)
            - Franchisors receive royalty payments from the franchisee, usually set as a percentage of the sales revenues
            - Franchisees have more incentives to do better than salaried managers, thereby increasing the chances of success for the franchisor
        - Franchisees

        - There are relatively lower start-up costs because the business idea has already been developed by the franchisor (such as market research, brand development and product development strategies)
        - There is relatively low risk because the franchisor has a tried and tested formula, so the chances of business success are statistically high
        - The franchisee is likely to benefit from large scale advertising used by the franchisor, i.e. franchisees receive 'free' advertising and promotion, which also helps to reduce their costs
        - Franchisees are still, technically, their own bosses, so have a large degree of autonomy in running their own business, within the parameters of the agreement
- Drawbacks
    - Franchisors
        - There is a huge risk in allowing other parties (franchisees) to use the franchisor's name.Unsuccessful franchisees can damage the reputation of the entire franchise business
        - It can be difficult to control the daily operations of all franchisees and to get them to meet the quality standards set by the franchisor
        - Although franchising is faster than internal growth methods, it is not as quick as other external methods such as M&As
    - Franchisees
        - Franchisees cannot simply use their own initiative to try out new ideas as they are overseen by the franchisor and the formal agreement. This could hinder the entrepreneurial talents of the franchisee
        - Buying a franchise can be very expensive, yet there is no guarantee that this investment will ever be recouped
        - Franchisees have to pay a significant percentage of their sales revenues to the franchisor